For professional investors

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Weekly Strategy Update

20 November 2014

SUMMARY

- **Japan: postponing tax hike after weak growth**
- **Eurozone's soft patch should gradually fade**
- **Asset allocation: new Australian flattener**

Joost van Leenders, CFA

Chief economist, Multi-Asset Solutions

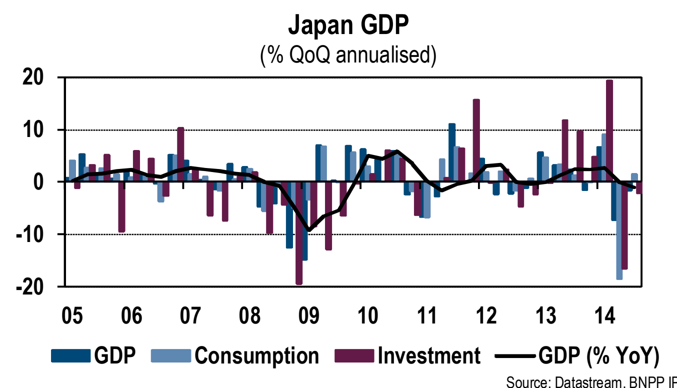
joost.vanleenders@bnpparibas.com

+31 20 527 5126

One of the surprises for us this year is the muted impact of geopolitical tensions on financial markets. Despite the unrest in the Middle East, crude oil prices have plunged. Increased tensions in Ukraine did not have much of an impact either. This pattern continued in the past week. Instead, Japan took the limelight with weak growth numbers which had immediate political consequences: snap elections are on the cards. The outlook for the economy is still weak, although factors for improvement may be stacking up. In our asset allocation, we have implemented a trade that would benefit from a flatter Australian yield curve. This is based on our perceived differences in monetary policy in Australia and the US.

JAPAN IN THE SPOTLIGHT

Expectations for third-quarter GDP growth in Japan were muted, but the actual outcome still disappointed. The economy shrank by 1.6% QoQ annualised. As it had plunged 7.3% in the second quarter, the economy thus slipped back into recession.



Source: Datastream, BNPP IP

So one could conclude that the hike in the consumption tax this spring had been too much too fast, but consumption actually eked out a small gain. However, the

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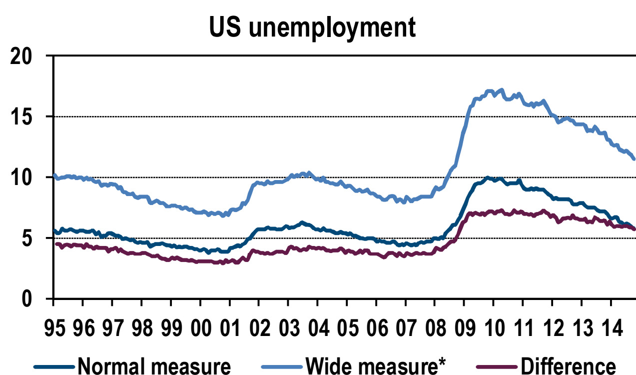
third-quarter bounce was from a low level and initial spending data for October was weak. Government spending and net trade were positive for growth, but declines in business investment, residential investment and inventories all detracted.

The main implication of the weak growth rate is that Prime Minister Abe is calling early elections. His popularity has fallen, but in the elections he will most likely keep his majority in parliament and a fresh term would give him more time to implement reforms. Renewed initiatives under his 'Abenomics' pro-growth and pro-inflation programme are badly needed. Last week I mentioned that confidence surveys showed the enthusiasm about 'Abenomics' has completely faded. In tandem with the call for early elections, Abe announced that the second step in the consumption tax hike, which was loosely planned for October next year, will be postponed by 18 months.

So some positive factors are stacking up for the Japanese economy, such as no tax hike next year, the Japanese yen falling to its lowest in seven years and lower oil prices. We are still cautious on the Japanese economy though. A weaker yen also means higher import prices and the government may want to find other ways than a hike in the consumption tax to limit the fiscal deficit. That said, a wider fiscal deficit will not have any implications for bond yields since the Bank of Japan is buying such large amounts of government bonds.

US CONSUMER MOVES AHEAD

The University of Michigan monthly survey showed that consumer confidence rose in early November to its highest since 2007. It took five years since the end of the recession, but consumer confidence has now finally returned to the averages normally seen outside of recessions.



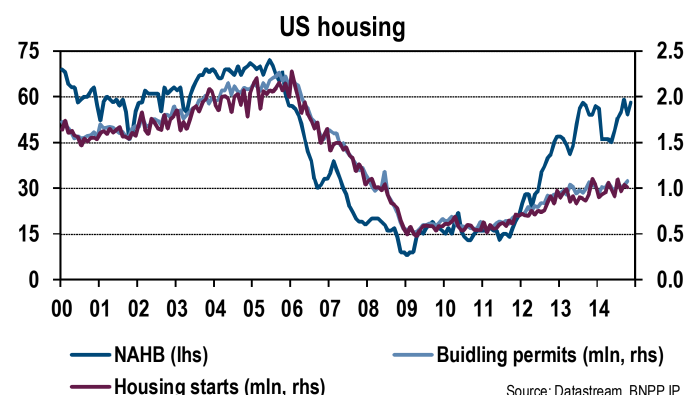
* Includes marginally attached workeres and unemployed for economic reasons

Source: Datastream

The slow pace makes sense since it also took a long time for the labour and housing markets to heal and for deleveraging to progress. Not everything is back to normal. Wage growth is still relatively low and the gap between the official unemployment rate and wider measures of unemployment is still unusually large. Anyway, the labour and housing markets have now improved and the drop in petrol prices to below USD 3 per gallon for the first time since 2010 is a more recent positive factor. This allowed retail sales to recover in October from the weakness in September. Stripping out car and petrol sales to get a clearer view of underlying consumption trends, the recovery in retail sales was actually quite strong. That sets the pace for stronger consumption growth in the current quarter than in the third quarter of this year.

Data from the industrial sector was weak, with industrial production falling and the Empire manufacturing PMI – the first of the monthly regional PMIs to be released – missing expectations. The Empire index had fallen steeply in October and November's improvement was modest. However, the index is still firmly in positive territory and manufacturing output was stronger than overall industrial production. The ISM manufacturing index may be overly optimistic at 59.0 in October, but a cross-check with the Markit manufacturing PMI, which stood at 55.9, confirms that we should not be worried about the US manufacturing sector.

Sentiment among homebuilders improved in November. This should have been positive for our overweight in US homebuilders' equities, but the market reaction was quite muted. This may be due to the trend in the NAHB index. After several months of improvement, the index had reached 59 in September. It fell in October and the rebound in November was not enough to compensate for this.

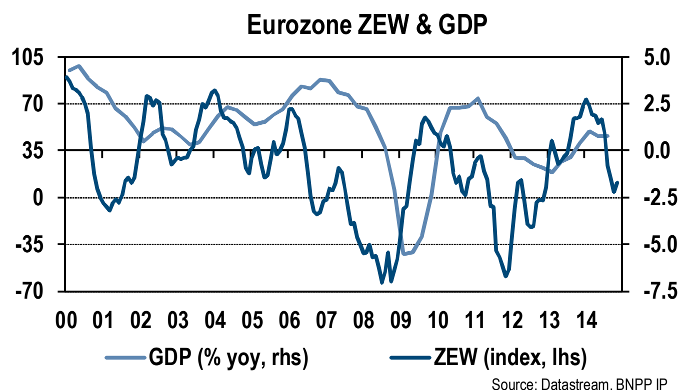


Source: Datastream, BNPP IP

Nevertheless, sentiment among homebuilders now points to increasing building activity, in our view. October data on construction activity look mixed at first sight, with a drop in housing starts and an increase in building permits. But the weakness in housing starts was concentrated in the volatile multi-family sector. Single family housing starts actually increased. So the underlying data fit with the gain in homebuilders' sentiment.

SLOW GROWTH IN EUROPE

The eurozone economy grew by a paltry 0.2% QoQ in the third quarter. That was marginally better than expected but below what we think is trend growth. Only the Italian economy shrank, while French growth was relatively strong. On an annual basis, Germany still did better than other major economies, with the exception of Spain. The challenge for the eurozone is still to increase the growth rate. Annual growth of 0.8% is not enough to lower the unemployment rate. After declines late last year and early this year, unemployment has stalled at a relatively high 11.5%. While low growth levels help to keep inflation (too) low, the combination of low growth and low inflation makes deleveraging more difficult.



Source: Datastream, BNPP IP

We think the soft patch should gradually pass. Lower oil prices and a depreciating euro are positive for the eurozone. Leading indicators do not point to much improvement in general, but the ZEW index may be the proverbial canary in the coal mine. This index, which measures sentiment among financial market experts, improved in November. After a steep decline since June, the outlook component was up, albeit modestly. The assessment of the current situation still fell, but at a slower pace than in previous months. Any improvement in the eurozone economy will be gradual, in our view.

In the UK, a dovish inflation report from the Bank of England with lowered growth projections and dovish remarks by BoE governor Carney who warned that UK inflation could fall below 1% led to a market re-assessment of the timing of the BoE's first rate hike. It was long thought that the BoE would hike before the Fed, at some point perceptions were that the first hike could come as early as at the end of this year. But after the report it looks more likely that the BoE will stay on hold for longer and might hike later than the Fed, which we think will move late in the second quarter of 2015. This had a marked impact on ten-year UK government bond yields which fell and on the British pound which depreciated. So it was positive for our long Mexican peso versus British pound position.

NO IMPROVEMENT IN CHINA

Real and financial data in China confirmed the picture of a slowing economy. In October, retail sales growth fell to 11.5% YoY and industrial production grew at only 7.7%.

Source: Bloomberg, BNPP IP

These are still relatively high growth rates from an international perspective, but in China growth has not been this slow for over a decade. Investment growth also slowed despite ongoing strong gains in infrastructure investment. Investment in manufacturing and real estate slowed significantly. Annual growth of bank lending and total social financing, a broader measure of Chinese credit growth, fell to their lowest on record. A small positive to note here is that credit growth should slow when the real economy is slowing, to keep the economy from becoming more unbalanced. However, at 16.0% YoY, broad credit growth is still much higher than nominal GDP growth (about 9%). So the economy is still leveraging up. This may be a longer-term risk. For now, I think the implication is that the economy is weaker than the headline growth numbers suggest. Looking ahead,

the authorities may keep trying to prop up the economy with stimulus measures or they may choose to let it slow further. I would not be surprised if the growth target for next year were trimmed to 7.0%, from the current 7.5%.

Elsewhere in emerging markets, India reported disappointing export growth in October. This fits with the trend we have seen in other countries. The graph below shows aggregate exports from six early-reporting countries. The overall growth rate was held up by China, which saw export growth decline to only 11.6% YoY, but outside of China, the picture is weak. Exports fell in Brazil, Chile and India and slowed in South Korea and Taiwan. So growth in emerging markets is still subdued.

Colin Graham, CFA, CAIA
CIO, head of TAA, Multi Asset Solutions

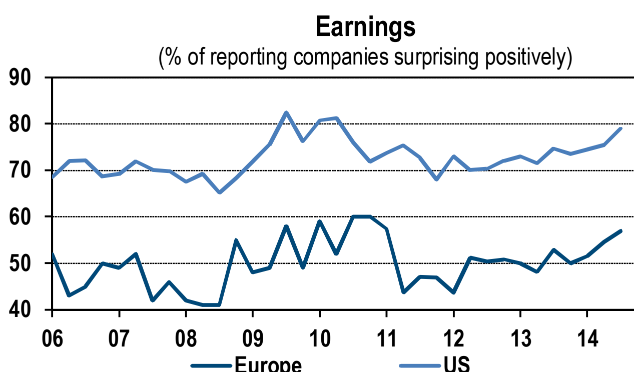
colin.graham@bnpparibas.com

+44 207 063 7778

ASSET ALLOCATION

Core positions

We are overweight in global equities. We still view the global economic cycle as negative on balance, with a rosy US outlook offset by the struggle of the eurozone, Japan and emerging economies to regain momentum. Monetary policy is positive, especially with the recent additional stimulus measures in the eurozone and Japan. Earnings have been a positive driver. Both in the US and in the eurozone, the percentage of companies reporting better-than-expected sales and earnings in the third quarter was higher than in previous quarters.



The lack of wage gains in the US has a silver lining. It enables companies to keep a lid on costs, which is supportive for margins. We remain overweight European large caps versus small caps since large-cap companies should benefit more strongly from slightly improved global growth. We consider European small caps expensive.

We have a small overweight in European high-yield corporate bonds, where we like the carry, low default rates and generally decent company balance sheets. We are also overweight in European investment-grade credit. This asset class may benefit indirectly from ECB asset purchases, which should push up the prices of asset-backed securities and covered bonds and lead to portfolio shifts into relatively safe investment-grade corporate bonds. High-yield and investment-grade have benefited from generally low bond yields and falling risk spreads in a risk-seeking environment.

We are neutral on US and German duration and neutral on real global estate, convertible bonds, commodities and cash.

Flexible multi-asset positions

We are overweight in US homebuilders' equities. Homebuilders have attractive valuations and large order books and profits should continue to grow decently.

We have a long position in 10-year US government bonds versus two-year bonds to benefit from a flattening of the US yield curve. Fed rate hikes, possibly from the second quarter of 2015, are not properly reflected in two-year yields: market data generally points to later hikes. The Fed appears determined to start hiking next year and has even commented on the difference between its own expectations and market pricing. If market expectations adjust, two-year yields would rise by more than 10-year yields. We think there is more curve flattening to come.

In contrast with the previous position, we are now overweight Australian three-year government bonds versus 10-year government bonds. This position would benefit from a steepening curve. The market is not discounting any changes in official interest rates in Australia. While the Reserve Bank of Australia recently left rates unchanged, it forecasts lower growth and inflation below its target next year. It sees subdued labour market conditions, low wage growth and no declines in

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Bloomberg and Datastream are the sources for all data in this document as at 19 November, unless specified otherwise.

unemployment. Discounting future rate cuts should cause the Australian yield curve to steepen.

We are overweight Mexican USD debt versus US 10-year Treasuries. We expect Mexican bonds to benefit from sound and improving fundamentals, falling inflation and low official rates. Mexico should be better shielded against the downside risks in China than other Latin American countries.

We are long European investment-grade bonds versus US investment-grade corporate bonds. We think the re-leveraging cycle has advanced much further in the US than in Europe (US companies have borrowed more in recent years). As said, ECB monetary policy could cause investors to rotate into corporate bonds if yields on ABS and covered bonds fall. If the ECB were to buy corporate bonds directly, there would be further support.

We are long Norwegian bonds versus Bund futures. Norwegian bonds offer a positive carry versus Bunds and are AAA rated. We expect the spread to narrow for fundamental and possibly cyclical reasons.

In the US, we remain long five-year forward inflation swaps (expectations of inflation five years from now).

We are overweight in German real estate versus US real estate. Monetary policy is more favourable for German real estate. US real estate, which is dominated by commercial real estate, has already seen fundamentals such as vacancy rates improve and this has now been discounted. In Germany, residential real estate is relatively more important and we believe it offers value.

In commodities, we are long in diversified commodities excluding industrial metals (i.e. long crude oil) versus a short in diversified commodities excluding energy (i.e. short industrial metals). We expect oil prices to recover given the pricing power of the OPEC cartel, uncertainty about future Libyan oil production and an insufficient premium for geopolitical risks. We see the outlook for industrial metals as negative: markets are oversupplied, the adjustment process is slow, there will be additional supply and demand is insufficient.

We are long the Mexican peso versus sterling and the Australian and New Zealand dollar, equally weighted. The peso is cheap in relative terms and the Mexican central bank may tighten monetary policy more aggressively than the Australian and New Zealand central banks. We are also long the Mexican peso versus the British pound.

We are long the Canadian dollar versus the New Zealand dollar, mainly because we see the CAD as cheap.

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WEEKLY STRATEGY UPDATE

14/11/2014	Strategy: US and Japan bourses extend lead on emerging markets
	ECB gears up for more action as eurozone bumps along the bottom
06/11/2014	Strategy: policy divergence sets market direction
	Profits taken on short positions in yen and European equities
30/10/2014	Strategy: market sentiment improves
	US shows signs of moderation; little chance of a shock in China
23/10/2014	Strategy: market stumble clears the way for equities overweight...
	...but topples tactical short duration in US Treasuries
02/10/2014	Strategy: risk-off mode prevails
	Asset allocation: limiting losses and implementing new trades
25/09/2014	Strategy: equities held at neutral despite downside pressures
	No strong catalyst for higher US yields in the short term
18/09/2014	Strategy: Fed comments support short duration in US govt bonds
	New: long crude oil versus short industrial metals
11/09/2014	Strategy: US dollar strength adds to euro, yen woes
	Several positions in asset allocation fine-tuned
04/09/2014	Strategy: US growth looks set to move into lower gear
	Will Draghi drag his feet or go for a kick-start after all?
28/08/2014	Strategy: central bankers still sitting on the fence
	Eurozone bounce might allow Draghi to hold off on QE

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MARKET OVERVIEW*

Indices	Close	5D %CHG	1M %CHG	3m %CHG	YTD %CHG	Currency
MSCI WORLD	1.728	0.77	7.11	-0.38	4.04	USD
Barclays Global Agg	207	0.14	0.09	1.09	6.21	EUR
Barclays Global High Yield	345	-0.60	0.52	-1.48	4.11	EUR
FTSE EPRA Global REITs	2.291	0.51	5.23	0.60	30.24	USD
Regional Indices						
S&P 500	2.052	0.59	8.75	3.54	11.01	USD
MSCI EUROPE x UK	124	1.89	6.93	2.01	3.37	EUR
FTSE 100	6.707	1.45	6.28	-1.07	-0.63	GBP
NIKKEI 225	17.289	0.53	18.97	11.90	6.12	JPY
MSCI Asia Ex Japan	566	-0.75	3.11	-5.48	2.69	USD
MSCI EMERGING Markets	989	-0.74	1.22	-8.83	-1.40	USD
J.P. Morgan EMBI $	674.81	-0.39	-0.51	-1.82	7.48	USD
J.P. Morgan GBI-EM local	103.93	0.23	-2.38	-7.15	-7.69	Local
Regional Bond yields	%	% 5D	% 1M	% 3M	%YTD	
US Generic Govt 10 Year Yield	2.34	2.37	2.19	2.40	3.03	USD
Germany Generic Govt 10Y Yield	0.84	0.81	0.86	1.00	1.93	EUR
UK Generic Govt 10Y Yield	2.13	2.19	2.19	2.40	3.02	GBP
J.P. Morgan EMBI $	5.83	5.77	5.71	5.41	6.10	USD
J.P. Morgan GBI-EM local	6.39	6.44	6.50	6.57	6.85	Local
FX						
USD	1.25	1.24	1.28	1.33	1.37	USD
GBP	1.25	1.27	1.26	1.25	1.20	EUR
JPY	147.39	143.64	136.89	137.09	144.73	JPY
CHN	7.68	7.63	7.85	8.18	8.32	CNH

* As at 19 November 2014. Source: Bloomberg, BNPP IP

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